

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

AN ADJUSTMENT OF RATES IN THE)
EAST LOGAN WATER DISTRICT AND)
FOR AUTHORITY TO REAMORTIZE) CASE NO. 9440
EXISTING BOND INDEBTEDNESS)

O R D E R

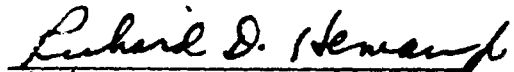
IT IS ORDERED that:

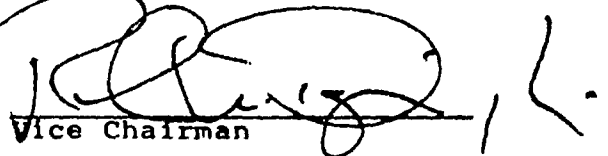
1. The Staff Audit Report for East Logan Water District ("East Logan") attached hereto as Appendix A shall be included as a part of the record in this proceeding.

2. East Logan shall have until the close of business March 14, 1986, to file written comments concerning the contents of Appendix A.

Done at Frankfort, Kentucky, this 7th day of March, 1986.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Secretary

APPENDIX A
REPORT ON LIMITED AUDIT
OF
EAST LOGAN WATER DISTRICT

PREFACE

On October 4, 1985, East Logan Water District ("East Logan") filed an application with the Commission requesting an increase in rates and for authority to reamortize its existing indebtedness. This application was accompanied by a motion from East Logan seeking emergency rate relief pursuant to KRS 278.190(2).

On November 8, 1985, East Logan's request for an interim increase was denied in part because of numerous deficiencies in both the general and interim rate application.

Because of the numerous filing deficiencies and in response to East Logan's request for staff assistance, the Commission staff chose to perform an audit, limited in scope, on the operations of East Logan. This decision was made in order to avoid further delays in processing this application through the use of lengthy information requests. The audit was conducted by Mr. Aaron Greenwell and Mr. Isaac Scott of the Division of Rates and Tariffs on January 30 and 31, 1986, at the offices of Hanks Construction Company ("Hanks").

SCOPE

The scope of this audit was limited to determining whether or not operating expenses, as reported by East Logan in the unaudited financial statements for the year ended June 30, 1985, ("Test Year") were accounted for in accordance with the Uniform System of Accounts for Water Utilities and were related to the test year. Each test year expenditure was reviewed, the minutes of East Logan's commissioners meetings from January 19, 1984, through September 26, 1985, were reviewed, an analysis of test year disbursements was compiled, invoices relating to most expenditures were reviewed, and workpapers of East Logan's CPA, Mr. Eugene Hargis ("CPA") were reviewed. Discussions were held with East Logan's Commissioners, Mr. Hargis and employees of Hanks to determine East Logan's financial policies and procedures and to answer questions relating to the accounting treatment accorded specific expenditures.

FINDINGS

East Logan, which began operations in October, 1980, has neither been audited nor requested any rate increases prior to the present application. A review of the accounting system revealed that East Logan's financial records were not maintained in accordance with the Uniform System of Accounts for Water Utilities as required by the Commission. With only minor exceptions, the test year expenses, as reported by East Logan, were for that specific period. However, East Logan's failure to maintain their books as required by the Commission resulted in the improper expensing of numerous capital items. Additionally, East Logan included as

income, items more properly classified as contributions in aid of construction.

Following is a discussion of the findings of the audit and recommended adjustments to the test-period operating revenues and expenses. East Logan's books are not maintained according to the Uniform System of Accounts and since it was not within the scope of this audit to restate the operations accordingly, the account titles used are those reported by East Logan:

Installation Charges

East Logan reported, as a component of revenue, installation charges of \$19,505. This amount includes tap-on fees of \$18,730 and line payments of \$775. The Uniform System of Accounts for Water Utilities requires that these items be treated as contributions in aid of construction. Therefore, test period revenues have been reduced by \$19,505.

Other Revenue

Other revenue of \$2,210 reported by East Logan includes a refund of \$1,202 of the premium on a cancelled insurance policy. This item is further discussed in the "Insurance Expense" section of this report. Additionally, East Logan included interest income of \$1,564 as a reduction of interest expense rather than include it under this classification. With the deduction of the \$1,202 and the addition of the \$1,564, the other revenue for the test year should be \$2,572.

Management Expense

In April, 1984, East Logan's Board of Commissioners ("Board") entered into a management agreement with Hanks. Under

the terms of the contract, Hanks is to furnish East Logan with an adequately equipped office, and management and supervision of the operations of East Logan in conformity with the policies, rules, regulations and requirements of East Logan and of the various agencies, departments and commissions of the Commonwealth of Kentucky.

The contract requires Hanks to maintain East Logan's water lines at a monthly fee of \$3.50 per customer.¹ This maintenance includes all necessary and proper services required in connection with billing and collection of water bills, receiving applications for new water services, staking new services and filing necessary permits and originating work orders, reading in and out customers that change locations, and performing other duties considered necessary. The contract further specifies that Hanks will maintain proper accounting records and submit monthly and annual reports to the Board. Emergency repair work is to be billed to East Logan at rates specified in the agreement and may be completed without Board approval if under \$500. Hanks is to be reimbursed for reasonable office supplies and is to operate East Logan in accordance with all federal, state and local requirements including those requirements relating to any federal financial assistance.

¹ Amended September 27, 1984, by East Logan's commissioners. The contract originally specified a flat fee of \$2,750 per month. This fee was changed to \$2,400 per month on July 31, 1984. At that time, it was decided that Hanks would read meters semi-annually at \$350 per reading rather than monthly.

During the test year, East Logan actually paid \$30,860 to Hanks for management expense. East Logan reported a test year expense of \$30,065. This amount reflected an adjustment reversing an accrual entry of \$795 to record the management expense payable at December 31, 1984. A conversation with Mr. Hargis revealed that the accrual should have been to contract labor. Therefore, the proper test-year management expense is \$30,860.

Line and Meter Supplies

East Logan reported a test year expense of \$13,862 for line and meter supplies. However, a review of invoices and discussions with the district's manager, C. K. Hanks, disclosed that \$12,921 was improperly expensed. The schedule below lists the checks, by payee, charged to this expense for the test year and includes the staff's determination regarding proper accounting treatment:

<u>Payee</u>	<u>Check No.</u>	<u>Amount</u>	<u>Capitalize</u>	<u>Inventory</u>	<u>Expense</u>
Wemhoener	1668	\$ 210.42	\$ 210.42	\$ -0-	\$ -0-
	1726	1,734.23	1,659.31	-0-	-0-
	1756	1,002.15	1,964.45	-0-	-0-
	1782	589.31	453.95	-0-	135.36
	109	31.04	-0-	-0-	31.04
G&C Water- works	1638	479.22	433.41	-0-	45.81
	1655	1,231.05	1,231.05	-0-	-0-
	1800	1,308.81	1,283.31	-0-	25.50
	3/14/85	1,245.90	1,046.72	-0-	199.18
	111	1,784.25	608.85	1,175.40	-0-
	134	210.72	210.72	-0-	-0-
	161	1,384.60	1,289.34	-0-	95.26

<u>Payee</u>	<u>Check No.</u>	<u>Amount</u>	<u>Capitalize</u>	<u>Inventory</u>	<u>Expense</u>
B&G Chemi- cals	1627	\$148.00	-0-	-0-	\$148.00
	1799	148.00	-0-	-0-	148.00
Rockwell	1746	823.70	\$823.70	-0-	-0-
Rock City Machinery	1766	<u>530.18</u>	<u>530.18</u>	<u>-0-</u>	<u>-0-</u>
Totals		\$13,861.58	\$11,745.41	\$1,175.40	\$ 940.77

Payments of \$11,745.41 were capital in nature and should be included in the appropriate plant accounts. The \$1,175.40 was for pipe purchased for inventory and resale and should be accorded the proper accounting treatment for items of that nature. Additionally, the expense of \$941 should be increased by \$1,291.60, including \$874 recorded as contract labor and \$417.60 recorded as pump and tank utilities. These reclassifications will be discussed later in the appropriate sections of this report. Therefore, the proper test-year line and meter supplies expense is \$2,233.

Meter and Tap-on Fees

East Logan reported payments of \$11,587 to Hanks for installing meters during the test year as an expense. A review of the invoices submitted by Hanks, revealed that actually \$14,068 was paid by the district for services performed in connection with meter installation or line extensions. The difference of \$2,481 was included in contract labor by East Logan and will be further discussed in that section. The Uniform System of Accounts requires that expenses of this nature be capitalized with entries

made to the appropriate plant accounts. Therefore, the test year expenses have been reduced by \$11,587.

Contract Labor

The expense for contract labor reported by East Logan for the test year was \$7,743. The contract labor trial balance prior to adjustments made by East Logan's CPA was \$59,732.91. This amount is verified by checks recorded as contract labor payments during the test year. The following is a reconciliation of the trial balance to the test year reported expense:

Checks recorded as contract labor	\$59,732.91
Deduct:	
Management fee - 7-1 through 12-31-84	(15,169.50)
Stevenson Mill Road Contract	(27,000.00)
Meter and tap-on fees	(11,586.83)
Add:	
Repair of FM Telemetry System	874.00
Accrual of June, 1985 payment for meter installation	<u>892.30</u>
Total	\$ 7,742.88

The staff review of this account included a verification of the total disbursements recorded as contract labor and an examination of the invoices and other documents supporting these disbursements. The minutes of the meetings of East Logan's commissioners supported the payments of the management fees of \$15,169.50 and the payments totalling \$27,000 to Hanks for the Stevenson Mill Road construction. The examination of the invoices revealed that an additional \$2,481 was expended for items related

to meter installation and line extensions but had not been included in the meter and tap-on fee classification used by East Logan. Additionally, Check No. 1768 in the amount of \$390.50 paid to Kondracki-Tinsley for engineering services on the Stevenson Mill Road construction was included as contract labor. This and other payments in connection with the Stevenson Mill Road project should be capitalized rather than expensed.

The \$874 for repair of the telemetry system has been classified as line and meter supplies expense by the staff. Additionally, an adjustment was made to accrue \$892.30 as contract labor. This amount was for the June 1985 invoice submitted by Hanks for meter installation and repair. However, this payment was actually made by Check No. 176 on June 26 which resulted in accounting for this expenditure twice in the month of June. This duplicate expenditure has been reversed by the staff.

Therefore, the expense for contract labor as determined by the staff should be \$3,105 and may be reconciled as follows:

Checks recorded as contract labor	\$59,732.91
Deduct	
Management fee - 7-1 through 12-31-84	(15,169.50)
Stevenson Mill Road Contract	(27,000.00)
Meter and Tap-on Fees	(14,068.00)
Kondracki-Tinsley	<u>(390.50)</u>
Total	\$ 3,104.91

Utility and Sales Tax

East Logan reported \$6,638 as the test year expense for utility and sales tax. The actual test year payments were

\$6,522.47. This amount was adjusted to accrue \$488.03 due but outstanding as of the end of the test year and by \$372.84 to reverse a prior period accrual to the 1984 year-end operations. This amount was paid during the test year by Check No. 1789, \$130.49, and Check No. 1790, \$242.35, and should be included in test year expenses. However, test year expenses should be reduced by \$311.48 which represent the June 1984 expenses paid in July 1984. Therefore, the test-year utility and sales tax expense should be increased by \$62 to \$6,700.

Office Supplies and Expenses

The reported test year expense for office supplies and expenses was \$4,841. This amount should be reduced by \$200 paid to Seaboard System Railroad in connection with the Stevenson Mill Road construction and by \$30.45 paid for insurance for July 1, 1985 through June 30, 1986. Therefore, the test year expense should be \$4,611.

Pump and Tank Utilities

The pump and tank utilities expense reported was \$3,139. An analysis of the test year expenditures and of the CPA's trial balance revealed that checks totalling \$4,798.48 were recorded as expenses and that an adjustment reducing this expense by \$1,659.48 was made. The adjustment reclassified \$1,659.48 as insurance expense. A review of the invoices revealed that \$1,462 was paid for insurance in June, 1985 and recorded in this account. The staff has determined that the \$1,659.48 actually represents the total amount of checks recorded in June 1985 as pump and tank utilities rather than misclassified insurance expense.

Examination of the checks and invoices revealed that the following checks should be reclassified to line and meter supplies:

Check dated 3-21-85 to Knowles Communication for sending unit repair	\$100.00
Check No. 107 to Auburn Electric for pump repair.	299.60
Check No. 112 to Auburn Electric for pump repair.	<u>18.00</u>
Total	\$417.60

The appropriate adjustment to the trial balance should have been \$1,879.60 which is the \$417.60 shown above and the \$1,462 insurance payment. Thus, an adjustment of \$220.12 to the reported expense has been made which produces an adjusted test year expense of \$2,919.

Insurance Expense

East Logan reported insurance expense of \$1,690. As discussed in the preceding section, that amount includes an erroneous adjustment of \$1,659.48. Prior to the test year, East Logan paid \$1,380 for fire and liability insurance covering the period from April 1, 1984 through March 30, 1985. The staff has prorated this amount at \$115 per month to determine the actual expense from July 1, 1984 through March 30, 1985, of \$1,035. In June 1985, East Logan paid \$1,462 for an insurance policy that was subsequently cancelled. East Logan was refunded \$1,202 with \$260 of the payment allocated to insurance from March 30, through May 31, 1985. Therefore, including a \$30.45 encroachment bond payment, the adjusted test-year insurance expense is \$1,325.

Water Refunds

East Logan reported as an expense water refunds of \$1,509. This represents refunds of deposits of \$869 and checks written by East Logan to transfer deposits from one checking account to another of \$640. These amounts do not represent expenses and should not be classified as such. If properly recorded initially, the \$869 should have been treated as a reduction to contributions in aid of construction, tap-on fees Account No. 271.1 and the \$640 should increase customer deposits, Account No. 235. Therefore, test-year operating expenses have been reduced by \$1,509.

Other Expenses

East Logan reported other expenses of \$489. The staff has reduced this amount by \$89 which represents payments of outstanding bills for operating expenses incurred prior to the test year. Therefore, other expenses for the test year have been included at \$400.

Interest Expense

East Logan reported test-year interest expense of \$56,949. This amount represents:

<u>Payee</u>	<u>Description</u>	<u>Amount</u>
Farmer's Home Administration	Original \$902,000 Bond	\$46,900
Farmer's Home Administration	Interest & principal in arrears	4,312
Citizens National Bank of Russellville	\$100,000 note	<u>7,304</u>
Subtotal		\$58,516
East Logan Water Dist.	Interest income	<u>(1,567)</u>
TOTAL		\$56,949

The Uniform System of Accounts requires that interest income be recorded separately in Account No. 419; therefore, the reduction for interest income has not been included in the test-year interest expense of \$58,516.

Depreciation Expense

East Logan reported test-year depreciation expense of \$51,803. This amount includes \$940 for depreciation of a leased computer. East Logan's CPA has determined this lease to be equivalent to an installment purchase for accounting presentation. However, a review of the minutes of the commissioners meeting and an analysis of checks written during the test year have led the staff to question this treatment. The staff has determined that since \$100 is being expensed monthly for the computer and since it was allegedly sold with all other equipment, according to the minutes of the May 17, 1984 board meeting, that it should be removed from East Logan's books and that depreciation be reduced by \$940.

Because of the limited scope of this audit, the staff has not determined the validity of East Logan's reported plant in service; therefore, except for the reduction for the depreciation of the computer, the staff has made no attempt to verify East Logan's depreciation expense. The adjusted depreciation expense for the test year is \$50,863.

SUMMARY

The following is a summary of the effect of these adjustments on East Logan's test-year operating statement:

<u>Revenues:</u>	<u>Test-Year Reported</u>	<u>Staff Adjustments</u>	<u>Test-Year Adjusted</u>
Water Sales	\$168,725		\$168,725
Installation Charges	19,505	\$(19,505)	-0-
Other revenue	<u>2,210</u>	<u>362</u>	<u>2,572</u>
Total revenues	\$190,440	\$(19,143)	\$171,297
<u>Operating Expenses</u>			
Water	\$53,819	-0-	\$53,819
Management expense	30,065	\$ 795	30,860
Line and meter supplies	13,862	(11,629)	2,233
Meter and tap-on fees	11,587	(11,587)	-0-
Contract labor	7,743	(4,638)	3,105
Utility and sales tax	6,638	62	6,700
Office supplies and expense	4,841	(230)	4,611
Pump and tank utilities	3,139	(220)	2,919
Insurance	1,690	(365)	1,325
Commissioners expense	1,850	-0-	1,850
Legal and accounting	2,719	-0-	2,719
Water refunds	1,509	(1,509)	-0-
Other	<u>489</u>	<u>(89)</u>	<u>400</u>
	\$139,951	\$(29,410)	\$110,541
<u>Non-Operating Expense</u>			
Interest - net	\$ 56,949	\$ 1,567	\$ 58,516
Depreciation	51,803	(940)	50,863
Amortization	<u>1,978</u>	<u>-0-</u>	<u>1,978</u>
Total non-operating expenses	\$110,730	\$ 627	\$111,357
Net loss	\$(60,241)	\$9,640	\$(50,601)

CONCLUSION AND RECOMMENDATIONS

It was previously stated in this report that East Logan had not maintained its books in accordance with the Uniform System of Accounts for Water Utilities. As evidenced by the numerous adjustments, this failure by East Logan resulted in their inability to present a true picture of their test year operations and has resulted in delays in processing the rate application.

The staff has reason to believe that additional problems exist. Due to the limited scope of the audit, the staff did not attempt to determine the accuracy of East Logan's plant in service and did not verify test-year depreciation expense. However, the staff is of the opinion that these account balances are inaccurate. During the test year, East Logan paid, from the proceeds of the Citizens National Bank loan, approximately \$31,464.94 in past due bills. Many of these appear to be capital in nature. At what point, if ever, these expenditures were entered in the plant accounts is questionable. Further, based on the numerous errors in classification during the test year, it should be assumed that similar problems in prior years result in understated plant balances, overstated expenses and improper retained earnings.

Problems also exist with the internal accounting and administrative controls in force at East Logan. The minutes of the commissioners' meeting of April 25, 1985, refer to an investigation requested by East Logan's current commissioners, performed by the United States Department of Agriculture concerning past management practices. The report concluded that evidence was found of mismanagement in the amount of \$90,000 by East Logan's

prior chairman and manager. The current commissioners and management have shown a willingness to attempt to correct past weaknesses in the internal controls. Yet, weaknesses were evidenced in the test year transactions reviewed by the staff.

The handling of the awarding and payment of a \$27,000 construction project on Stevenson Mill Road is an example. From the evidence reviewed by the staff, the contract was not awarded through formal competitive bidding, a written version of the contract and its terms did not exist, and payments were made to the contractor based on his oral request for funds, no invoices or work in progress reports were submitted to support the requests. The situation is further complicated in that the contractor was the firm which also managed East Logan, Hanks. While no evidence existed to indicate the selection of Hanks was improper, the procedures used by East Logan in this matter demonstrate that internal controls were weak.

In addition, the use of Hanks exclusively for repair projects not covered by the management contract indicates another weakness in internal controls. The larger dollar projects were not awarded through competitive bidding. No job orders or work in progress reports were submitted with the invoices for materials and labor. A supplies inventory record, tracking the items used on specific jobs as well as the available inventory, has not been maintained. Also, in the September 27, 1984 minutes, the secretary for Hanks was authorized to sign checks for East Logan. While no evidence of improper practice by Hanks was found, the current situation has the potential for such abuses.

The scope of this audit did not permit a detailed study of the internal accounting and administrative controls; however, the staff became aware of these weaknesses during the course of the limited audit. In order to address the internal control weaknesses noted, the commissioners of East Logan should review the current management contract and related operating procedures. Additionally, East Logan should immediately adopt the Uniform System of Accounts as required by the Commission, and follow its guidelines for accounting treatment of revenues and expenditures. Further, East Logan should determine the appropriate accounting adjustments and revise its books accordingly.

Respectfully Submitted,

Aaron Greenwell

Aaron Greenwell
Principal Public Utilities Financial
Analyst
Public Service Commission
Division of Rates and Tariffs
Revenue Requirements Section